RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

November 1, 1978 **LETTER 742**

Oct. 20, DJIA 838.01; PTI 928; A-D Ratio –19.62
Oct. 27, DJIA 806.05; PTI 897; A-D Ratio –21.94

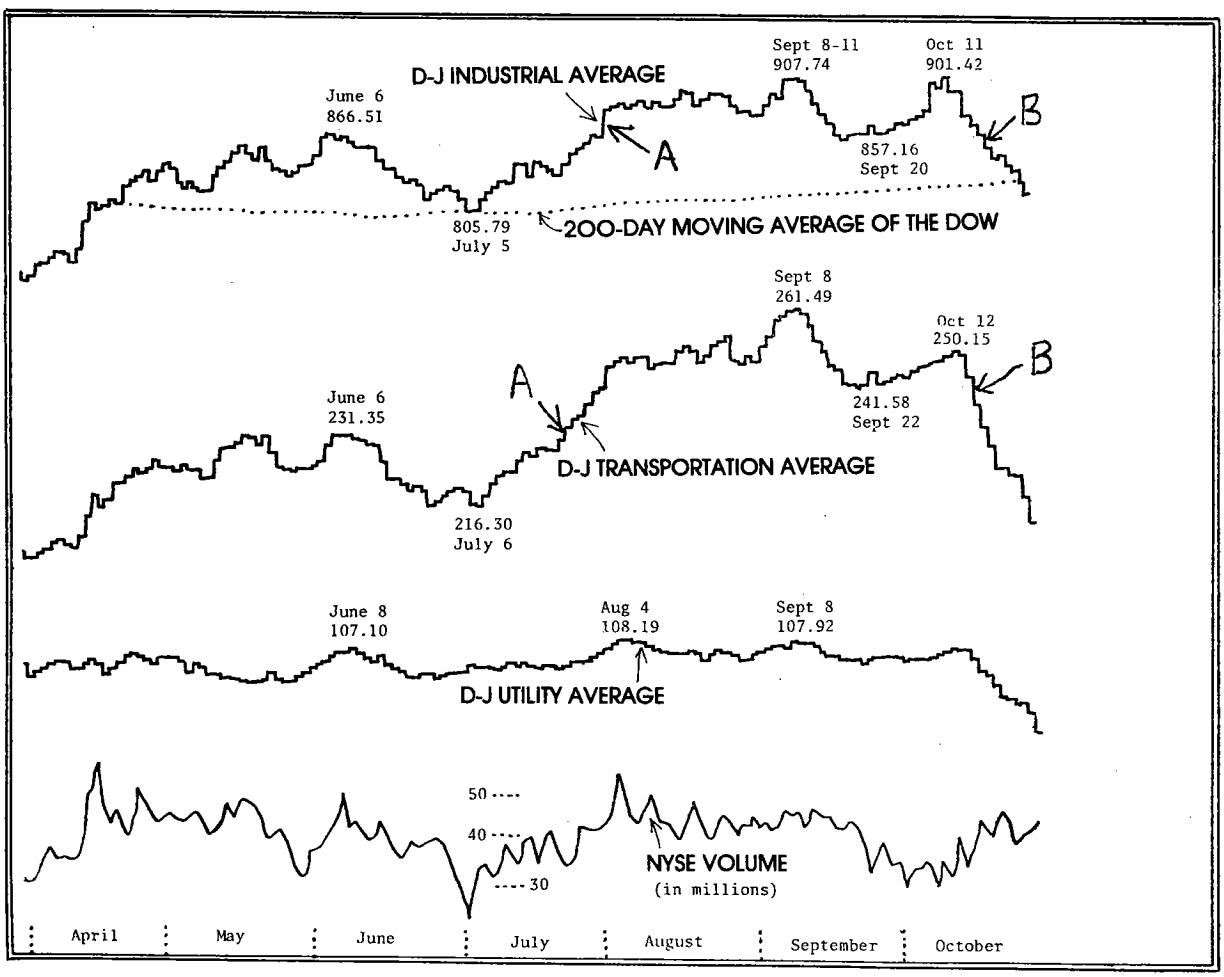
BEAR SIGNAL: Study the chart of the Averages below. At the point marked "A" the two Averages bettered preceding secondary peaks. Here (on August 22) the cry went up, "New bull market!" I disagreed, saying that Dow's Theory entailed a good deal more than a "mere mechanical reading of the Averages."

I noted that every bull market in history had started from an over-sold base, but that this market had not seen an over-sold condition since late-1976. I also observed that the bellwether Utility Average had not performed bullishly prior to, or even after, the so-called "bull signal." Furthermore, I noted that the monetary background was totally bearish, and it was hardly providing the kind of setting from which a new bull market would start. Speculation in secondary stocks had been rampant, volume had been very heavy (speculative), and it was clear that everyone was only too willing to agree that indeed "we are in a new bull market." But history shows that when bull (or bear) markets really begin, Dow Theory signals are generally greeted with derision, skepticism and scorn—rather than wholesale agreement!

Back to the Averages: the Industrials and Transports pushed up to peaks recorded on September 8. A decline carried to September 20-22, whereupon a new advance began. The advance (see last Letter) was characterized by a lagging Transportation Average and sluggish breadth. On October 11-12 the advance fizzled out, and the Averages turned down. I warned in the last Letter of the bearishness of the price structure and the implications of a breaking of the 857.16 (Industrial) and 241.58 (Transport) lows. On October 17 the Transports shattered their 241.58 low and two days later, on October 19, Industrials smashed their own low of 857.16 ("B" on chart).

A strange silence hung over Wall Street as the Averages and the breadth of the market embarked on a devastating decline. The silence, I felt, was remarkable in view of the mangled price structure. No cries of "bear market" filled the air. No stentorian voices proclaimed that "the tide had turned." Two "Dow Theorists" interviewed in *Barron's* (Oct. 23) "The Trader" column avowed that the bull trend was still in force.

Maybe so, but from the standpoint of Dow's Theory a full-fledged bear market signal was given on October 19. If further confirmation was needed, on October 20 the bellwether Utility Average sank below its February 21, 1978 bottom (below 102.54), thereby dropping to its lowest level since December 1976!



So it's finally happened. At this point I can say that the stock market (the Averages, breadth, high-lows, most-active stocks), the bond market, the trend of interest rates,the all-important monetary indicators–are ALL IN HARMONY. And they are on the downside (except for interest rates, which of course are on the upside).

I am going to try to be as cold, as unemotional, and as objective as I can be on this market from here on. I think things are going to move fast, and I still am looking for some sort of massive happening (a turning point) to appear around July, 1979. I base that on my Fibonacci studies, and if it does occur it will be most fascinating. But I want to tell subscribers again that I am going to LET THE MARKET DO THE TALKING.

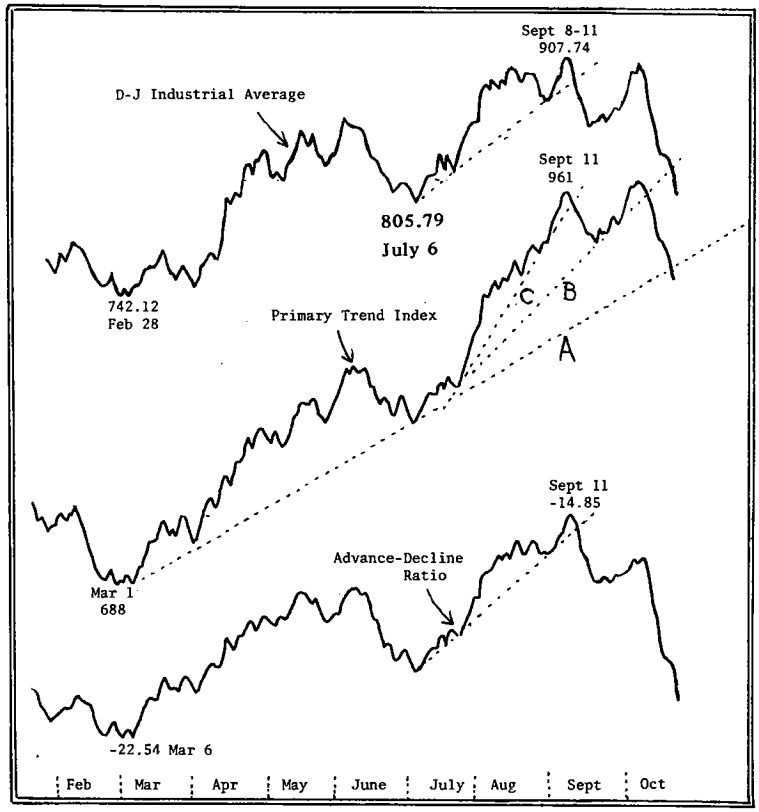
As this is written, my twin indicators (see Letter 731, p. 3) are in over-sold territory for the first time since October, 1976. They have moved into "over-sold" via one of the worst breadth collapses in the history of the NYSE. In 10 consecutive sessions the A-D ratio has dropped over 4.96 points! I've never seen anythink like that in 10 days, and I have to think that it's both meaningful and ominous.

But remember: this market (despite negative monetary conditions) moved into over-bought territory in April, 1978 and the market stayed over-bought (with a pause during June-July) until early-September. Every market action tends to breed an equal and opposite reaction. The counter-reaction to the March-September over-bought condition is what has produced the current breadth crash on the NYSE, the AMEX and the over-the-counter markets. On top of that, we have the unheard-of total of $12.4 billion in margin on the NYSE. If a large portion of this margin is to be "called," no one knows what will happen.

The downside compression of the past few weeks, as I said, has been terrific. That means there will be rallies, and perhaps VIOLENT rallies. If I think the situation looks ripe for an entrance on the buy side (for trading purposes), I will say so. Right now, I want all my subscribers to **stay out** as per my instructions in Letter after Letter.

The new low list is exploding, and many speculative favorites have now collapsed. The D-J 65 Stock Average is now at roughly its January 1, 1978 level and the NYSE and S&P Composites are only slightly above their January 1 levels. What really worries me, however, is Wall Street's "leaning Tower of Pisa," the $12.4 billion in margin debt. If that topples over, well . . . .

I have received many phone calls, letters and queries from frightened people who want to know "How could this have happened?" The extraordinary thing really is why so many investors (and advisors) were trapped in this market. In Letter 737 I discussed the extended divergence in the Averages, and I stated that the Averages were providing us with "a long term indication of danger." In the same Letter I drew attention to the two major speedlines which converged at the 900 area, and I wrote that if the Dow cannot decisively "hold above the 900 level, then my feeling is that the trouble is about to start." In Letter 739 I included the "speculative index" while commenting that this index was at a dangerous record high. In the same Letter I pointed to the Fibonacci 910 level on the Dow, stating that the 907.74 peak of September 8 could be the ultimate high. So what I'm saying is that the danger signals were there for all to see. The market was fairly shouting its warnings–for those of us who cared to listen.



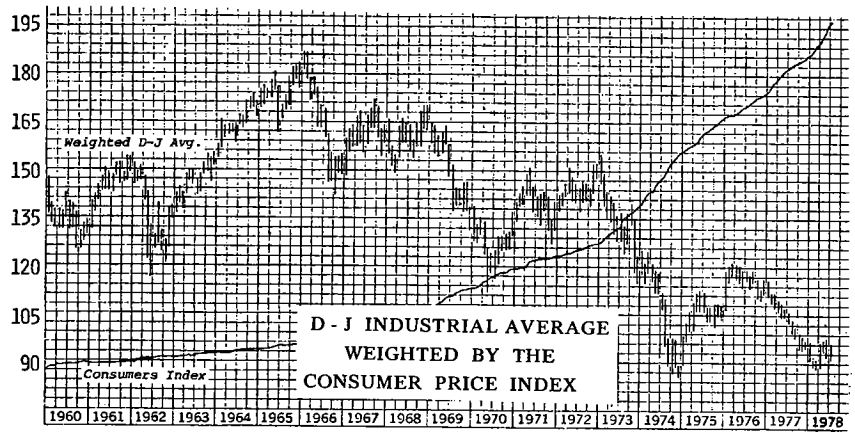
My daily chart of the Dow, the Primary Trend Index (PTI), and the A-D ratio provide an instructive view of the recent action. Trendline B on the PTI was broken on October 17. The major trendline (A) was violated on October 27. Thus, a major bear signal has now been given by the PTI, and it is confirmed by the Dow and the A-D ratio.

From the high of September 11, the A-D ratio entered a sickening collapse which, by October 27, had lopped off 6.64 points. This takes the A-D ratio far below its July low and within a very short distance of the March 6 low for the year (at which time the Dow was at 742.12). A decisive break by Industrials below 805.79 (its July 5 low) would mean that the Industrial Average had confirmed the A-D ratio through the July lows. In that case, I would think that Industrials would be in line to test their low for the year at 742.12. Conversely, a stand at 805.79 for the Dow would represent a downside non-confirmation between price and breadth, in which case some kind of rally would be in order.

The violence and rapidity of this smash has few precedents in stock market annals. Seldom have optimists, speculators and crap-shooters been punished so drastically and so relentlessly. All of which serves to reinforce, in my own mind, a lesson which I learned many years ago. Don't go against your own trusted indicators, don't go with the crowd, don't do the easy thing, trust your tools and stick to your own procedure. That's probably the most important lesson I've learned in the markets, but I'm always amazed when it's reconfirmed by subsequent events

THE PICTURE: Most of the great fortunes have been made in the market by men who saw the long-term trend of events, took a position accordingly, and then held onto that position through thick and thin until their vision was proved correct.

The best example of this procedure I have ever seen was from the great Dow Theorist, E. George Schaefer. Schaefer set up two accounts totalling $100,000 in 1949. He held those accounts during the entire bull market of 1949 to 1966. During late-1965



and early 1966 Schaefer sold out his portfolios. The final tally (including dividends) came to $1,107,785. Thus Schaefer showed a profit of about a million dollars on an initial investment of $100,000. This profit was a result of simply riding the primary trend.

I believe that the stock market has been in a major primary bear market ever since February, 1966. In Letter 738 I presented my long-term views on the entire price movement from 1932 to the present. I am including that chart again below because I believe it is one of the most important charts I have ever prepared, and I want subscribers to fix it firmly in their minds.

The bear market that began in 1966 has been one of the most vicious and deceptive in history. My friend, Jim Dines, calls it "The Invisible Crash" (also the title of a book he wrote). The crash started out subtly enough. It started with the rate of inflation slowly rising, and thus the purchasing power of the dollar was slowly diminishing. By 1970 the inflation rate was accelerating at an uncomfortable rate. The rate dropped off during 1972-74, then picked up to the double-digit level during 1974. A temporary easing of the inflation rate was seen during 1975-76, and then during 1977 and 1978 the inflation rate began accelerating again. But each rise in the inflation rate has been from a higher base. Today, in 1978, inflation and the collapse of the dollar's purchasing power have become the major political issues in the nation.

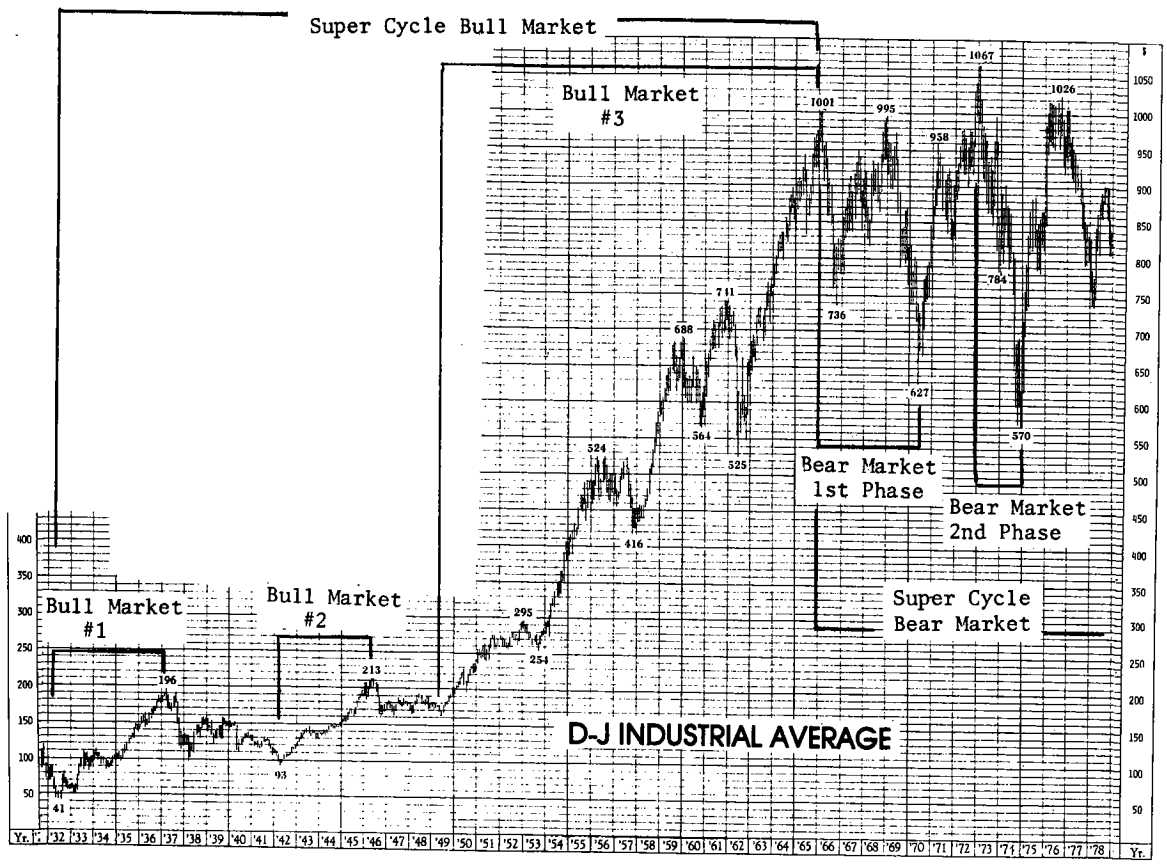
Everyone has seen one of those charts showing the Dow in terms of 1946 or 1939 dollars. But in case you haven't, this is a chart (courtesy of *Horsey*, Salisbury, Md.) showing roughly the same thing—the Dow adjusted for changes in the Consumers Price Index. In terms of what the Dow will buy, it is clear that the 30 big industrial shares have been in a 12-year bear market.

Nevertheless, the fact is that the actual (unadjusted) Dow is now below its average price of the past 13 years (or 156 months), that average price now being roughly 870. On October 26 (on a shorter-term basis), the Dow broke below its 200 day moving average. This is the first bearish penetration given by the Dow since it broke below its 200-day moving average in January, 1977 (see p.1 chart). With inflation rampant today, that doesn't say much for the Dow!

But note on the large chart below that I have shown the market as having completed the first phase of the bear market and the second phase as well. In my opinion we are moving closer and closer to the third or final phase of this bear market. During the first and second phases we saw the Dow make three drives to lower levels. In October, 1966, the Dow hit 744.32. In May, 1970, the Dow sank to 631.16. In December, 1974 the Dow smashed to 577.60. Following each of these collapses, the Government opened the money spigots and the Dow rallied back to the 1000 level amid a new tide of rampant inflation.

At present, the inflationary forces are more severe and persistent than at any time since World War II. The debt situation is also more precarious. Finally, speculation has certainly been as intense as any time in the past 30 years, and margin debt on the NYSE (now $12.4 billion) is at an all-time high.

Now in order to actually halt inflation, the US is going to have to take some extremely unpleasant steps. The US is going to have to stop spending more than it is taking in, and it is going to have to stop monetizing the debt (i.e., printing money). But as



I've said so many times before, this nation now **exists** on deficits. Cut out the deficits and we go into depression. So we've come to the point where we will either have no currency or no prosperity (not even an "inflationary prosperity"). We've got to make the choice or our foreign debtors are going to make that choice for us.

One sign of the times is the move towards a new European currency. Foreigners know what is coming up, and they don't want to be in the dollar's way when it comes down the rest of the way. Thus, we see the rapid progress towards the ECU, an all-European gold-backed currency that should get off the boards early next year.

But to get back to the bear market. I said in Letter 738 that what bothers me (and this even bothered me in 1974 when I was bullish on stocks) was that the bear market had never "squeezed the water out of the economy." Yet bear markets exist for the purpose of shaking the tree, knocking down the fat plums, squeezing the water out, and building a firm base for the next bull market.

Somewhere in the period ahead, we are going to see the real "third phase bear market action" in the Dow and most other stocks. True, during 1973-74 the majority of stocks were pulverized in a slide that was comparable to 1929-32 in many ways. But the Dow lost less than 50% of its value at that time. My guess is that before the third or final phase of this bear market is over, we are going to see the Dow at drastic new lows, we're going to see dividends cut across the board, we're going to see very high interest rates, and we're going to see something that this generation has never seen before–wholesale liquidation of debt in all sections of the economy, private, corporate and perhaps even government. At that point, there won't be a man or woman alive who won't know that there's a bear market in force. And it won't be "an invisible crash" any longer. It will be a crash of the biggest debt structure the world has ever seen.

However (there always seems to be a "however"), there is one thought that has been preying on my mind. It is this. The primary bear market which began in 1966 has been *extending and extending* (in duration), just as did the bull market which began in 1949. Each time it looks as if the "plug is going to be pulled," the bear market (with the help of huge infusions of monetary inflation from the Fed) pulls itself out of the hole.

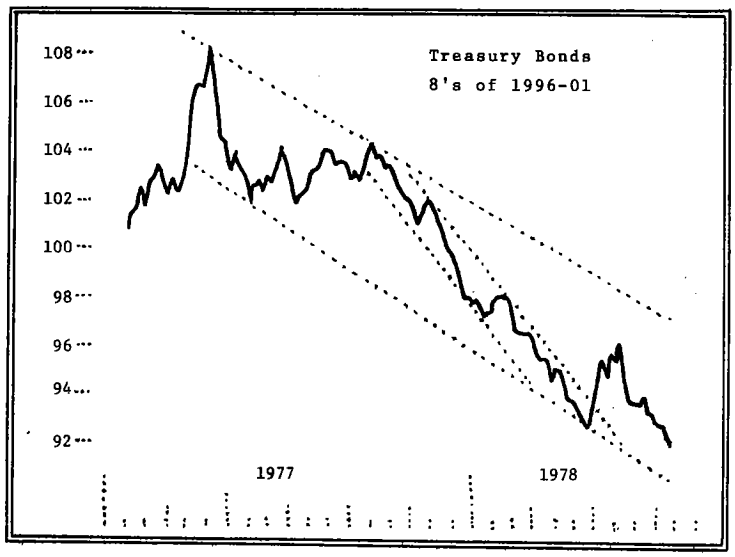
I want subscribers to consider the following very carefully. There is a potential for one final inflationary explosion. It is the inflationary explosion that "should have come" during 1975-76. But OPEC's massive boost in the price of oil aborted that inflation by siphoning off billions of dollars (the new cost of oil). Those billions were the fuel for hyper-inflation.

Now there is a **new** fuel. During the years 1975 through 1977 about $220 billion was spent on currency intervention in an effort to support the dollar. Foreign nations (our creditors) had to create mountains of new money for their dollar-support operations. Thus, the money supply all over Europe has moved dramatically higher. This massive rise in world liquidity could exert its full inflationary force somewhere in the next year or so. An inflationary boom could come this winter, it could come in a year or so–or it could start almost immediately.

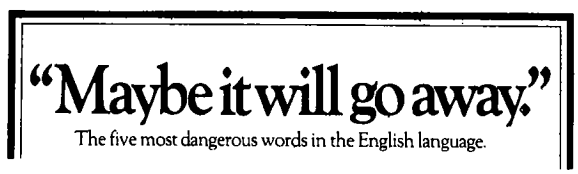
Thus, we find ourselves in the midst of a situation where the forces of inflation and deflation are waging an ever more ferocious battle with each other. Efforts to deal with these opposing forces should produce wilder, more violent and more confusing markets in ALL AREAS including gold, commodities, currencies, bonds and stocks. We're moving into very difficult times, and I want to be prepared for anything. But the accent in all cases is going to be on TIMING.

Question: Russell, the third phase of a bear market that keeps being put off; a potential inflationary explosion; confusion in the markets–I get it but I don't. What do I do about it?

Answer: Sit tight for now–with gold and Treasury bills. Those who have bought gold when I told them to should now have profits of up to 50%. They have also avoided the wipe out in the market of the past month. Relax, and let's allow the market to do a little more "talking." I'm not ready to make any change in our "gold and T-bills" position –yet.



MONEY: Late last week the money market went into semi-panic. Large C/D's were drawing 10.37% to 10.50% interest, and the Government bonds broke to new lows. Perhaps this chart of the bellwether Treasury 8's of 1996 says it all. Here we see the 93 support area giving way as these bonds break to near 92, at which level they provided yields of over 8.7%. Meanwhile the new Government two-year notes (8 7/8's) maturing in 1980 went over 9% in yields! Just about that time I got this little five-word notation from Sheldon Dike (brilliant portfolio manager) from Albuquerque. You don't have to tell me, Sheldon, I know it won't go away!



NOTES & QUOTES: Books: Harry Browne's new book, "New Profits from the Monetary Crisis" is now on the stands (publisher is Morrow). Harry has an uncanny ability to cut through the fog and render difficult subjects understandable. He also has two great gifts, intelligence and an ability to write clearly. Browne deals with all aspects of surviving in an unstable world. This book is must reading, even for the super-sophisticate. Yards and yards of useful information, facts, figures, ideas, concepts.

I just finished a highly amusing book (paperback) entitled "On the Brink" by Benjamin and Herbert Stein. The book tells the fictional story of a weak US President, a populist Federal Reserve

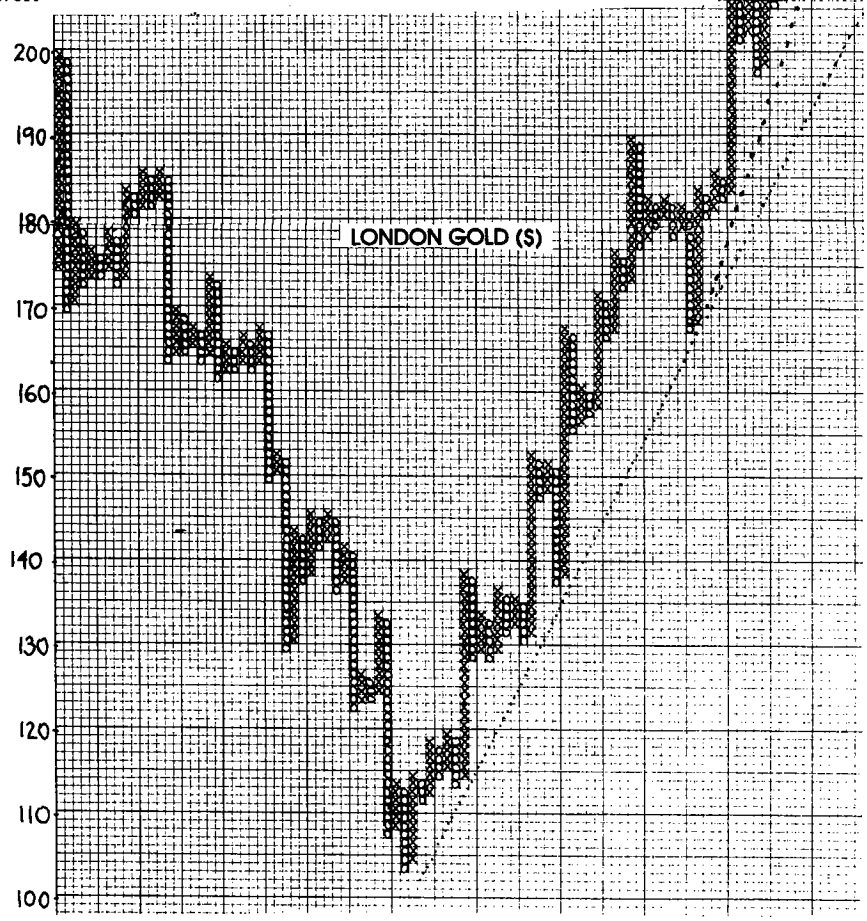
Board Chairman and rampant inflation. We read of $2 million an ounce for gold, a $6 thousand taxi ride from Kennedy Airport to NYC, and riots and pillaging from Coast to Coast. I must say that I found the book interesting (hardly joyous) reading. The climax has the Chinese cornering the world gold market! If hyper-inflation is our fate, this may be a preview. Try it, you'll loathe it.

Many new subscribers are not aware of it, but I publish chart albums of the D-J Averages (Industrials, Transports, Utilities, Bonds and volume) showing all daily action going back to 1885 —one page for each year. The charts are large, 8½" by 15" in hard-cover loose-leaf binders. New pages are available each year. I consider these albums a must for any serious student of the market and any investor who wants to have an idea of market action. Price is $49 ($52 for Californians).

* *

The 76 nations that report on the value of their reserves to the IMF show that they now hold $140 billion in dollars or roughly 80% (!) of their reserves in the dollar. Opinion among many experts is that these nations are now embarking on a long-term program of diversifying out of the dollar. This is most ominous, because it means that despite any and all respites and rallies, the dollar is going to be under pressure. Because the 76 nations do not want to further depress their dollar reserves, they will probably tend to hold dollars while taking in gold and foreign currencies (other than the dollar) for new reserves.

It took 20 years for British sterling to be reduced to normal proportions in the portfolios of major nations. And that, in the opinion of many experts, is the way the diversifying trend out of the dollar is going to go. On this basis, cold-eyed observers (such as the writer) see the US as having passed its peak of economic power.



GOLD: Slowly, very slowly, it's dawning on the world that we're witnessing one hell of a bull market—in gold. I've been writing pages and pages about gold in each Letter, trying to get new subscribers in the metal (or the coins), trying to get older subscribers to STAY in gold. Happily, a large percentage of my subscribers are now sitting with large gold positions. And the paper profits (in terms of dollars) are mounting.

The tremendous scope of the gold bull market can be seen on my 1 X 3 point & figure chart. Each box on the chart equals one point, while only rallies or declines of 3 points or more are shown. The X's denote rallies, the O's are declines. As you can see, I have drawn a *new steeper rising trendline*, and if this new trendline holds (I think it will) we should be going into a more dynamic stage of the gold rise. So far, we've been watching gold plod higher, climbing, backing-and-filling, pushing nervously onward. But from here on, I "feel" that the upward pace may quicken. I don't think I've ever seen any price movement rise gradually but relentlessly higher—without that rise ultimately turning into an upward surge. In my opinion, the higher gold goes in its current "careful" way, the higher the target when the metal finally turns emotional and speculative.

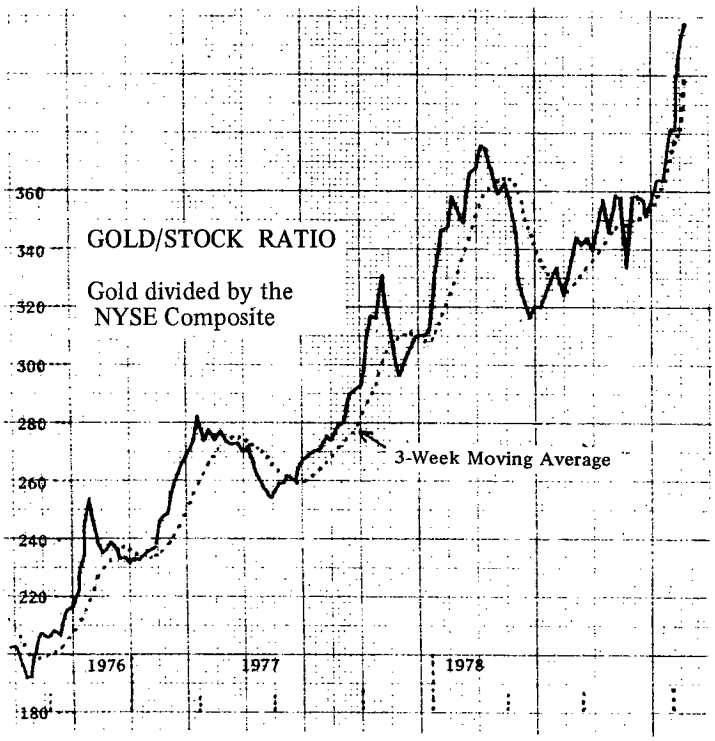
This non-confirmation between gold and the gold stock average which I discussed in the last Letter is still in force. Many feared that the reactionary tendencies in the gold shares were calling for a correction in gold. For this reason, many advisors have been telling their clients to sell their gold or even short gold. The consequences have been unhappy for the sellers, disastrous for the shorts. (See chart, page 6)

I believe that what is happening now is that we are seeing a wide SPLIT between all common stocks and commodities. The **entire commodity complex is turning bullish** at this time. The chart I showed of the CRB Commodity Index in the last Letter is nearing an upside breakout. Gold is a commodity as well as being real money. Under the leadership of gold (and to a lesser extent silver and platinum), the entire commodity spectrum from wheat to soybeans to copper to hogs is starting to move higher. Just as important, businessmen, investors and traders are turning increasingly to commodities as a hedge against inflation (they know that commodities will be the last items subject to possible price controls). Commodities, in short, are becoming the biggest game in town—and the most dynamic inflation hedge. I believe this relatively new trend is the basis of the split between the gold stocks and gold. People want the metal—gold. But they are lukewarm on the shares. Speculators and traders see gold as a "hot" commodity; they see the gold shares as "just another brand of common stocks."

At any rate, I continue to urge my subscribers to stay with the metal and leave the gold stocks alone. We could be moving into the area where gold, which has been in such an orderly, grinding rise, is going to amaze everyone with its strength and persistent rallying power. There are now hundreds of sold-out bulls in the gold pen, and other thousands who have yet to buy their first Krugerrand. The "gold fever" is **starting** to become visible—just starting.

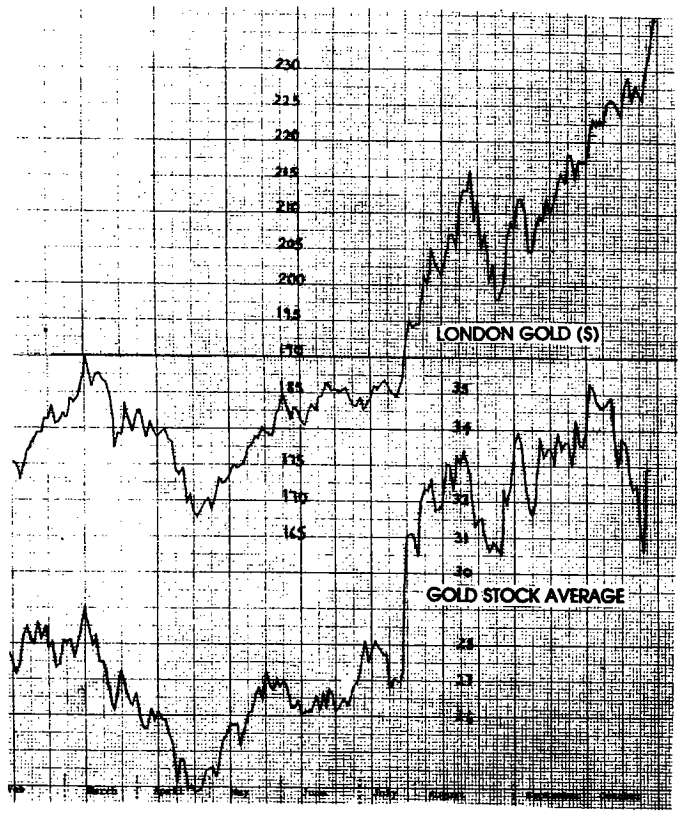
My 13-week momentum (rate of change) for gold has been holding at 121 for three weeks running. This means that gold is roughly 21% above its price of 13 weeks ago, a very respectable and profitable rate of climb (amounting to 1.6% per week). But my guess is that when gold becomes speculative, the momentum is going to push well above this level. In 1974 the momentum index for gold topped out at a whopping 180. The momentum index can be very useful in identifying a major top. What usually happens is the momentum hits a high along with price. Then there is a decline in both. Next price will go to a new high while momentum flattens out. At this point we have a major sell signal.

The bottom chart shows gold and its three moving averages (MA's). At present, the 4-week MA for gold is 227, the 13-week MA is 214, and the long-term or primary MA is 186. As long as bullion holds above the 224-27 area, it will remain strongly bullish.



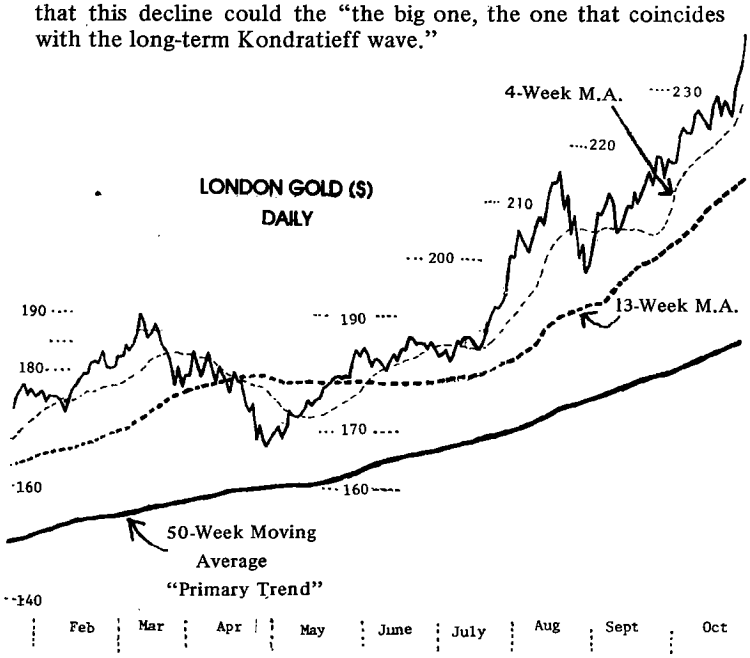
LATE NOTES: All 34 of Barron's stock groups (not including gold) have declined two weeks running. I've never seen that before. In two weeks the Wilshire Index, which includes all NYSE stocks, all AMEX stocks, and hundreds of O-T-C stocks (5,000 stocks in all) has declined $113 billion. I've never seen that before. I'm told that a blizzard of margin calls are going out now. I've seen that before, but never with margins at over $12 billion. So I'd say that this market has a downside head of steam on it. It's over-sold now, but it can stay over-sold for weeks if it chooses to. So let's bide our time. A panic bottom is almost always tested (there is a rally and then a second decline which approaches and usually penetrates the original panic bottom).

When you read this Letter I'll be in New Orleans speaking at the largest monetary conference ever assembled. Jim Blanchard sent telegrams out to say that every one of the 2300 seats have been sold, and that there's no more space for anyone, friends, relatives and cousins included. Jim is to be congratulated on his years of work on these Conferences and his tremendous pioneering efforts towards legalizing gold and for honest monetary reform. Jim, I don't know what the "soft money boys" and



the inflationists are saying, but I know what my charts are saying. The middle chart on this page shows the ratio of gold to the broad NYSE Composite. The ratio is about to blow off the top of the page. And that means that "gold is winning." When men seek to spend what they haven't got, when they try to produce money that isn't money, then gold shows them up as the liars and inflationists that they are. But my chart doesn't lie. It says that real money is winning and that corporate America is suffering. And this is one chart that Washington can't manipulate!

I want to take the last paragraph of this Letter to thank Tony Henfrey of S. Africa for giving me the original idea of a gold/stock ratio. And I want to congratulate my friend Joe Granville (who I haven't seen since 1960) for his superb market calls over the last 4 years. Joe, by the way, states in his most recent letter that this decline could the "the big one, the one that coincides with the long-term Kondratieff wave."



NEXT LETTER : November 15th